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Stealth compensation: Do CEOs increase their pay by influencing dividend policy?☆

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ABSTRACT

Companies can increase executive compensation by allowing dividends to be paid on unvested restricted stocks grants, also known as stealth compensation. Examining all S&P 500 firms over the period 2003–2007, we find that more than half of the dividend paying firms allow this practice. We look at whether this form of compensation reduces agency costs or decreases value for shareholders. We find that CEOs' stealth compensation amounts to an average of $180,000 in additional income, which increases the CEOs' cash compensation and total compensation by 9% and 2% respectively. Firms engaging in stealth compensation have higher dividend payout ratios than those not allowing stealth compensation. For all firms using stealth compensation, there is a reduction in average ROA and Tobin's Q over the long run. However, stealth compensation companies with potential agency issues see a meaningful improvement in their long run performance. For weakly governed companies, stealth compensation may act as a bonding mechanism which may serve to reduce agency costs and therefore increase shareholder value.

1. Introduction

With the increased attention on executive compensation, particularly cash compensation, directors have created alternative ways to enhance a CEO's compensation (and their own) without attracting shareholder attention. One such method is allowing management to receive additional income from dividends on unvested restricted stock grants (RSGs). RiskMetrics dubbed this type of compensation "stealth compensation" since companies are not required to clearly report this additional dividend component as part of an executive's compensation package.[2] It is not surprising that such hidden compensation exists at many firms, given shareholder pressure to reduce or change how executives are compensated. Chidambaran and Prabhala (2009) find that firms often engage in behavior to offset restrictions on compensation by using substitutes that can increase costs to shareholders. In this paper, we examine the degree to which firms engage in stealth dividend compensation, focusing on CEOs in particular, whether it is a meaningful contributor to overall compensation packages, and if it creates agency problems.

Stealth compensation could influence decisions involving dividend policy by creating incentives for companies to increase their dividend payout, which could either reduce or exacerbate agency issues. Shareholders of firms with cash flow exceeding

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[2] RiskMetrics used this term in a 2008 report on dividend compensation and we adopt it in this paper. Under SEC reporting rules, this income is not considered compensation, so firms are not required to include the exact dollar amount that executives receive in their proxy statement.

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their profitable investment opportunities want excess free cash flow paid out as dividends to prevent wasteful spending. Directors may use stealth compensation as a tool to motivate CEOs to push for increased payouts, which ultimately may benefit shareholders. Shareholders would get a higher current cash return, although at the possible cost of foregoing profitable projects. Additionally, tax-exempt institutional investors would be attracted to stocks with high dividend payouts since they are taxed at a lower rate than individual investors (Allen et al., 2000). The resulting increase in institutional ownership may lead to more active monitoring of the firm, which could reduce agency issues.

Alternatively, agency issues could be magnified if the CEO, working with the board, uses stealth compensation to maximize their own as well as the directors' compensation. Additionally, if the use of stealth compensation motivates managers to pay out cash to shareholders rather than invest in potentially profitable investments, the overall value of the firm can be negatively impacted. In particular, companies with risk averse managers or managers who want to lead “the quiet life” might prefer stealth compensation (Bertrand and Mullainathan, 2003). This too may decrease value for shareholders.

We focus on dividend-paying S&P 500 firms that allow dividends to be paid on unvested RSGs from 2003 to 2007 and compare them to dividend-paying S&P 500 firms that do not allow stealth compensation. During this time period, tax preferences between dividends and capital gains are minimal, which provides a unique opportunity to examine whether stealth compensation affects dividend policy. We find that CEOs make an extra $180,200 a year on average from dividends on unvested RSGs. This amounts to 9% of their total cash compensation and 2% of their total compensation, both significantly greater than for CEOs of firms without dividend compensation that could have been received if their firms allowed these payments. In order to better understand the factors affecting the use and impact of stealth compensation, we incorporate different measures of governance and institutional ownership into our analysis. We find that companies that use stealth compensation have greater board independence, higher institutional ownership, more entrenchment provisions, and lower governance transparency than companies that do not follow this policy.

Our results are consistent with stealth compensation influencing payout decisions. Stealth compensation firms have significantly higher dividend payout ratios and spend significantly less on repurchases than firms that do not engage in this practice. We find that the more RSGs a company has, the stronger the effect of stealth compensation. Interestingly, we see significantly higher dividend and lower repurchase payouts in firms that have high institutional ownership and offer stealth compensation. These results suggest that stealth compensation may act as a bonding mechanism to ensure that institutional owners get higher dividends, and that entrenched managers pay out excess free cash. We find a similar result for firms with poor governance and stealth compensation. We incorporate several methods to deal with endogeneity and find that our overall results are similar.

Finally, we look at the operating performance of firms engaging in stealth compensation and those which do not. Firms using stealth compensation experience significantly worse operating performance, both in terms of ROA and Tobin's Q, than firms not engaging in this practice over the subsequent three-year period. Interestingly, performance is significantly better for poorly governed firms that use stealth compensation compared to firms with poor governance but no stealth compensation. These results provide support for the possibility that stealth compensation is used by firms with poor governance to reduce agency issues.

Our paper proceeds as follows: Section 2 reviews related literature and our motivation, Section 3 describes the data, Section 4 discusses our results, and Section 5 presents our summary and conclusions.

2. Literature and motivation

2.1. Literature

There is a vast literature on both dividend policy and executive compensation. Recent evidence suggests that dividend payout ratios and the number of dividend-paying firms have declined (Fama and French, 2001), and that share repurchases have become a preferred method of payout for many firms (Grullon and Michaely, 2002); Jiang, Kim, Lie and Yang (2013). It has been suggested that one reason that dividends have become less popular is the increased use of company stock options as a form of compensation. These options are not protected against the decline in stock price when its goes ex-dividend. Consequently, their expected value is a decreasing function of dividend payments.

Lambert et al. (1989), Jolls (1998), Fenn and Liang (2001), and Kahle (2002) find that the firms offering managers more stock options as compensation tend to pay dividends to a lesser extent. Chetty and Saez (2005) and Brown et al. (2007) provide evidence of a negative relationship between executive stock options and the likelihood of a dividend increase after the 2003 reduction of taxes on dividends. These papers all focus on the role of options in setting dividend policy. We build on this literature by examining how another form of compensation, namely stealth compensation, affects dividend policy.

Aboody and Kasznik (2008) assess the underlying rationale for shareholders to design incentive contracts that induce managers to make payout choices that increase the value of their stock-based compensation. They find that the 2003 reduction in taxes in dividends resulted in greater alignment of the desires of individual (tax-paying) shareholders with those of management by inducing the latter to switch to RSGs from options. Blouin et al. (2011) jointly test the impact of the 2003 tax reduction on individual investors and management using the 2001–2005 data and find that firms with the largest individual ownership increased dividends relative to share repurchases starting in 2003. Moreover, they argue that their results are consistent with officers and directors increasing their holdings in order to take advantage of the reduced taxes on dividends.

Zhang (2013) also looks at the effects of dividend compensation on payout for S&P 500 stocks using the period from 2000 to 2009. She finds that dividend increases are more likely after 2003 for firms that pay stealth compensation. We also examine